MCI Telecommunications Corporation

MCI

1801 Pennsylvania Avenue, NW
Washington, DC 20006

November 9, 1998

Ms. Magalie R. Salas
Secretary
Federal Communications Commission
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

Re: In the Matter of Access Charge Reform, CC Docket No. 96-262; Price Cap Performance Reform for Local Exchange Carriers, CC Docket No. 94-1; Consumer Federation of America, Petition for Rulemaking, RM-9210

Dear Ms. Salas:

Enclosed herewith for filing are the original and four (4) copies of MCI WorldCom's Reply Comments regarding the above-captioned matter.

Please acknowledge receipt by affixing an appropriate notation on the copy of the MCI WorldCom Comments furnished for such purpose and remit same to the bearer.

Sincerely yours,

Henry G. Hultquist

Enclosure
HGH

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of:	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
	)	
Consumer Federation of America, Petition for Rulemaking	)	RM-9210

MCI WORLDCOM, INC. REPLY COMMENTS

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SUMMARY

The Commission's market-based approach to achieving cost based access charges has failed. There is no evidence whatsoever to support the assertions of some commenters that local exchange and exchange access markets are substantially competitive. In fact, the evidence shows that the incumbents have effectively resisted all entry strategies, and that competitors have been limited to facilities-based entry. In establishing the market-based approach, the Commission expected near-term competition from the use of unbundled network elements and combinations of those elements. But the record shows that UNE-based competition has not materialized. By itself, facilities-based entry will not promote cost-based access charges for the forseeable future.

The Commission must prescribe reductions to interstate access charges based on the forward-looking cost of providing access services. No commenter has proposed any realistic alternative that can yield cost-based access charges. The arguments made against prescription are either unfounded or irrelevant to the goal of achieving cost-based access charges.

The Commission should increase the X-factor to at least 10 percent. The most reliable data in the record indicate that such an increase is justified by recent interstate productivity improvements. ILEC arguments against an interstate-only productivity factor are unsound, as they themselves have argued before state commissions.

USTA's pricing flexibility proposal is even more seriously flawed than the proposals of Ameritech and Bell Atlantic. If adopted, it would effectively deregulate ILEC access services at a time when those companies enjoy near-total monopolies in the markets for local exchange and exchange access services. The Commission should reject this proposal and instead adopt the pricing flexibility framework which MCI WorldCom proposed in its Comments.

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MCI WORLDCOM, INC. REPLY COMMENTS

I. Introduction

Comments filed in the above-captioned proceeding are exceptionally revealing for what they do not contain -- evidence that the exchange access market will succumb, at any time soon, to the dynamics of a competitive market. As the comments reveal, the leading indicators of the presence of competition are simply not present. When prices decrease, it is due to the operation of regulatory formulas that require prices to decrease. New services, such as expanded interconnection, are introduced because regulators compel them, and the regulatory debates about new services are characterized by customer and regulatory concern that prices are too high, with the ILECs seeking to defend their high pricing. It is not surprising that with no evidence of competitive pricing and no evidence of market-driven innovation, that the comments also characterize the exchange access market as one where there are no real choices for access

customers. Exchange access remains a service provided virtually exclusively by incumbent monopolists.

There can be no question that the Commission's 1997 vision of "market-based reform" of interstate access is not in evidence as the industry prepares to enter 1999, and that regulatory action is needed to bring prices to cost. As MCI WorldCom, Inc. (MCI WorldCom) stated in its comments, the Commission should reduce access to cost on a date no later than it implements an explicit universal service fund.[1]

The incumbent local exchange carriers' (ILECs)' claims that the local exchange and exchange access markets are characterized by "vibrant competition" are transparently absurd, and are thoroughly refuted by the extensive evidence placed on the record by MCI WorldCom and other non-ILEC parties, as well as repeated findings of the Commission in section 271 and other proceedings.[2] The evidence shows that ILECs continue to maintain market shares in the switched access market that exceed 98 percent, and -- several years after the adoption of the Commission's expanded interconnection orders -- still collect over 90 percent of transport revenues. Only a monopolist would believe that a market in which one firm's share exceeds 98 percent is "vibrantly competitive."

Even more absurd is the ILECs' contention that it is too soon to evaluate the success or

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[1] MCI WorldCom Comments at 3.

[2] Not surprisingly, not a single ILEC referenced the Commission's continued rejection of Regional Bell Operating Company (RBOC) section 271 applications. In MCI WorldCom's view, the Commission should pay particular attention to the results of these applications, since they are the most detailed objective records of the progress of local competition to date, and they clearly demonstrate the utter failure of the RBOCs to take the prerequisite steps necessary to open their local markets.

failure of the market-based approach. The record demonstrates that competitive pressures sufficient to constrain the ILECs' access charges do not exist today and will not develop in the foreseeable future. Commenters show that ILECs' continued refusal to comply with their statutory duty to provide unbundled network elements (UNEs) at cost-based rates and in a nondiscriminatory manner has foreclosed any possibility of widespread local market entry. The Commission should acknowledge that the market-based approach will not work as long as facilities-based entry remains the only viable path for competitors to enter the local market.

Because there is no reasonable prospect that market forces sufficient to constrain the ILECs' interstate access charges will develop, the Commission must now turn to prescriptive measures in order to achieve its goal of driving interstate access charges to forward-looking economic cost.[3] The Commission should also find that the record supports an X-factor of at least 10 percent, with a one-time adjustment of that factor back to 1995, and should reject the ILECs' self-serving and contradictory claims that there is no basis for an interstate-only productivity factor.

The Commission should also reject USTA's latest pricing flexibility proposal, which would grant the ILECs near-complete pricing flexibility today. While MCI WorldCom's Comments described a reasonable framework under which the ILECs could obtain additional pricing flexibility, USTA's new plan is even more unreasonable than the proposals previously advanced by the ILECs in this docket. The USTA proposal is designed to allow the ILECs maximum flexibility to shift the "fat" in access charges to those services, geographic areas, and

[3] MCI WorldCom estimates that interstate access charges are approximately $10 billion in excess of their forward-looking cost.

end users for which competition will be slowest to develop, and is also designed to give the ILECs the tools they need to deter competitors from entering the local market.

Finally, MCI WorldCom agrees with the commenters who recognized that the Commission cannot approve RBOC section 271 applications or merger applications as long as access charges are above cost.[4]

II. Competition Has Not Developed Sufficiently To Reduce ILEC Access Charges

As MCI WorldCom demonstrated in its Emergency Petition and its comments in this proceeding, the ILECs have successfully resisted the development of widespread local competition through litigation and their refusal to provide competitors with cost-based, nondiscriminatory access to UNEs and combinations of UNEs.[5] Even in the market for high-capacity transport services, on most routes MCI WorldCom has no choice other than the ILEC.[6] Nonetheless, the ILECs insist that "local exchange competition is vibrant,"[7] and that "there is intense competition in the market for access services."[8] MCI WorldCom eagerly anticipates the day when local exchange and exchange access customers have robust alternative providers among which to choose. That day has not yet arrived, thanks in large part to the ILECs'

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[4] Reducing access charges to cost is a necessary, but not sufficient, element of the public interest inquiry in such applications.

[5] MCI WorldCom Comments at 11-18.

[6] Id., Appendix B, Rehberger Affidavit at ¶ 23.

[7] E.g., Ameritech Comments at 5.

[8] US WEST Comments at 15.

successful anti-competitive tactics to reduce the ability of new entrants to provide competitive services.

A. ILEC Policies That Have Thwarted Local Exchange Competition Have Effectively Eliminated Realistic Switched Access Competition

There is no competition for switched access services. As MCI WorldCom has shown, at present, local competition is primarily limited to facilities-based competition.[9] Moreover, the Commission, in an uninterrupted string of rejections of RBOC section 271 applications, has recognized that not only is local competition not robust, but that the RBOCs have not even taken the necessary steps to open their monopoly markets to competition. However, in their comments, ILECs cite a number of misleading statistics and indicators in support of the erroneous proposition that local exchange competition is becoming quite robust. MCI WorldCom responds to these arguments, below.

1. Interconnection Agreements

Several ILECs support the USTA pricing flexibility proposal which relies upon the existence of interconnection agreements as evidence that barriers to local exchange competition have been eliminated.[10] As every competitive local exchange carrier (CLEC) knows, an interconnection agreement is a necessary, but far from sufficient condition for local

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[9] Even in a world of robust facilities-based competition, interexchange carriers (IXCs) that are not affiliated with the local service provider are not able to select a local provider for switched access services. In these situations, the choice of an access carrier is made by the end user as a byproduct of selecting a local carrier.

[10] E.g., BellSouth Comments at 16

competition.[11] In a given state there might be dozens of signed interconnection agreements, and no customers with any real choice of local service provider. Moreover, the section 271 applications rejected by the Commission make it abundantly clear that signed interconnection agreements alone do not equate to effective local competition. The Commission's inquiry into the extent of local competition must focus on ILEC *actions* to open their markets as required by section 251 of the Act, rather than on how many pieces of paper they have signed.

2. Network Deployment

The ILECs make much of the number of switches and the amount of fiber installed by CLECs.[12] Yet they fail to put these investments into perspective by comparing them with their own investment in switches and transmission capacity. As MCI WorldCom and others have shown, CLEC investments in switching and transmission capacity constitute only a tiny fraction of what the ILECs have installed.[13] As long as competition is limited to these facilities, it will develop quite slowly, and the vast majority of customers will continue to be unprotected against unchecked monopoly anti-competitive pricing.

3. UNEs

The ILECs insist that competitors are making significant headway by using unbundled loops. They point to seemingly impressive numbers of "cumulative" loops that have been provisioned to CLECs.[14] Once again, they do not put these limited gains into perspective by

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[11] See, e.g., AT&T Comments, at 10, KMC Comments, at 4-5, CTSI Comments, at 5-6

[12] Ameritech Comments at 5-6.

[13] See, e.g., MCI WorldCom Comments, at 8, n. 14, Ad Hoc, Comments, at 4.

[14] Ameritech Comments at 6.

comparing it to the total number of loops in service. MCI WorldCom and other commenters have demonstrated that unbundled loops are a minuscule percentage of the ILECs' total loops in service.[15] Moreover, this Commission has repeatedly found that the RBOCs do not provide nondiscriminatory access to unbundled loops.[16] There is no basis whatsoever for concluding that local competition is thriving through the availability of unbundled loops.

MCI WorldCom agrees with Time Warner that the ILECs' resistance to providing collocation on nondiscriminatory terms and at cost-based rates, is impeding the development of competition through UNEs and through CLEC facilities.[17] MCI WorldCom would support Time Warner's suggestion[18] that the Commission establish national collocation rules, as a way to standardize and simplify the process and avoid further ILEC intransigence.[19]

It is significant that the ILECs do not even attempt to claim that CLECs are using unbundled switching, unbundled transport, combinations of UNEs, or indeed any UNEs other than loops. The Telecommunications Act foresaw the importance of all these elements. There will be no widespread local competition until CLECs are able to obtain nondiscriminatory access

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[15] See, MCI WorldCom Comments, at 7-8, Competition Policy Institute Comments, at 6-8.

[16] In the Matter of Application of BellSouth Corporation, BellSouth Telecommunications, and BellSouth Long Distance, Inc., for Provision of In-Region, InterLATA Services in Louisiana, Memorandum Opinion and Order, CC Docket No. 98-121, ("Louisiana II"), ¶ 136.

[17] Time Warner Comments, at 6.

[18] Id.

[19] ILECs have generally insisted that CLECs combine UNEs through collocation. The Commission specifically rejected this collocation-only requirement in rejecting BellSouth's second 271 application for Louisiana. See Louisiana II at ¶ 169. ILECs have effectively denied CLECs the ability to offer service through UNE combinations.

to all UNEs, as well as combinations of UNEs.

4. Resale

Several of the ILECs cite the number of resold lines as evidence of extensive competition. They again fail to put such competition in perspective. Resale competition is irrelevant to exchange access competition. When CLECs provide local exchange service through resale, the wholesaling ILEC, not the reseller, provides the associated exchange access services, and receives the access revenue. There is no constraint on ILEC access pricing. The Commission should disregard evidence of resale competition when evaluating competition for exchange access services.[20]

5. Market Share

With all their claims of "vibrant" local exchange competition, one would expect the ILECs to provide some evidence that CLECs have actually taken a substantial share of the market. Of course, they do not.[21] SBC recommends that this Commission not place too much evidence on market share data "that might indicate relatively large ILEC market shares, particularly in the switched access market segment."[22] Indeed, the data does indicate impressively large ILEC market shares. As MCI WorldCom demonstrated in its comments, ILECs have maintained market shares in excess of 98 percent. Of course, the Commission

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[20] Moreover, MCI WorldCom agrees with statements in recent ILEC merger applications that resale is not a viable market-entry strategy.

[21] As the Competition Policy Institute noted in its comments at 7, **"by the end of 1998, competitors to the ILECs will serve only about 1.4 million (0.8%) of the nation's estimated 177 million access lines through UNE-based entry"** (emphasis in original).

[22] SBC Comments at 7-9.

should not disregard market share data. These extraordinarily high market shares are hardly compatible with vibrantly competitive markets.

B. Significant Access Competition Does Not Exist Even In The Transport Market.

If there is one area of access that would appear to be most inviting to competition, it would be in the area of switched and special dedicated transport. This is the access function for which, in most cases, the vendor is selected by the IXC rather than the end user, and the level of competition is not dependent on competitive local exchange competition (as is switched access). Yet, even in this one area that has had almost a decade to develop, and was not dependent on statutory changes to the law, as mandated by the 1996 Act, ILEC access customers confirm in their comments that dedicated transport competition is fragmentary and growing slowly.[23] For example, AT&T cites the Commission's statement in the MCI WorldCom Merger Order which recognizes that "even in the market for business customers in the New York metropolitan area . . . the incumbent LEC has lost only six percent of the market to competitors."[24]

MCI WorldCom has had a long history of reviewing ILEC pleadings, and has found that in the few occasions over the years that the ILECs have actually had (at least some) evidence to back their constant refrain that competition is flourishing in a particular area, they have attempted to back their claims with page after page of the most minute detail. That is why the scant evidence of transport competition offered here by the ILECs in their comments is so telling. ILEC evidence in its entirety consists of one or two bald assertions that competitors have won a

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[23] Ad Hoc Comments, at 3-10.

[24] AT&T Comments, at 5.

high percentage of special access or dedicated transport circuits in a particular market.[25] Particularly relevant is the fact that not a single ILEC provides for Commission perusal the amount of actual transport *revenue* they have lost in even their most "competitive" markets, nor do they provide the amount of switched and special dedicated access revenue they have lost in transport as a whole. They cannot, of course, since this information would thoroughly discredit their claims of "widespread and effective" competition. Instead, they are forced to resort to using a DS1-equivalent measure, which as Sprint points out, is misleading and overstates the amount of transport revenue that has been lost to competitors. As Sprint states,

> [l]arge customers, including interexchange carriers, increasingly tend to purchase transport facilities in units of DS3 and even larger capacity. Although a DS3 is the equivalent of 28 DS1s in terms of capacity, the price of a DS3 is far less than 28 times the price of an individual DS1.[26]

Nor do ILEC comments reveal the fact that transport competition is limited to only the densest routes in larger cities, and further limited to entrance facilities between IXC points of presence and their serving wire centers. For example, Sprint notes there is "far less competition for dedicated transport all the way to the end user premises."[27] Sprint further states,

> [e]ven in those instances where alternative vendors can be used all the way to a customer premises, the fixed cost of a conversion and the difficulties in obtaining landlord and customer consent to the use of an alternative vendor, are such that there are no appreciable cost savings to Sprint in using alternative vendors, which lessens their ability to exert effective pressure on ILEC access charges. In 1996, only nine cents of every special access dollar spent by Sprint went to non-ILEC vendors. By January 1998, this figure had increased only slightly: alternative

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[25] See, e.g., Ameritech Comments, at 5, claiming that customers hold 60 percent of the DS1 equivalents in Chicago.

[26] Id., at 11.

[27] Sprint Comments, at 4.

vendors accounted for only 9.6% of Sprint's total access facility expenses.[28]

The ILECs predictably do not focus on the fact that they still receive the lion's share of revenue for interoffice dedicated transport between their serving wire centers and end offices, and almost 100 percent of the revenues for the channel terminations from end offices to customer locations. Nor do their comments reveal the fact that they also maintain virtually 100 percent of the revenues for the dedicated portion of tandem-switched transport between the tandem and their serving wire center, and all the common transport revenue between their end offices and tandems. Moreover, ILEC comments predictably ignore the fact that they still provide almost 100 percent of the dedicated multiplexing customers must purchase at the serving wire center even when they utilize a competitive entrance facility.[29]

ILECs are also silent regarding the fact that through their high month-to-month rates for transport services and their excessive termination liabilities, they lock-in customers to long-term contracts, ensuring that the only potential business available to competitors is for new, or "growth" circuits.[30]

Finally, ILEC comments ignore the fact that if ILECs were truly forced to respond to significant transport competition, they would price accordingly. Yet as AT&T notes, virtually all the price cap ILECs are continuing to price at the maximum allowed for each price cap basket, even for the Trunking basket containing transport services.[31]

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[28] Id.

[29] MCI Comments at 19, Rehberger Affidavit, at ¶ 24-26.

[30] Id., Rehberger Affidavit, at ¶¶ 14-17, 19-23.

[31] AT&T Comments, at 10-11, n. 7.

Bell Atlantic's comments are indicative of the limited and unconvincing "evidence" of transport competition provided by the ILECs. Bell Atlantic states that 10 percent of its switched traffic is carried over the transport facilities of its competitors,[32] but fails to note that this still leaves it in control of 90 percent of the switched dedicated transport market, and close to 100 percent of the switched access market. Bell Atlantic also claims that competitors have almost half the market for high capacity services in major urban markets such as New York and Washington D.C.[33] However, it does not explain how this measure was derived, nor whether it is calculated in misleading DS1 equivalents (as MCI WorldCom assumes) or revenue.

BellSouth's "demonstration" of the "fierce" competition for dedicated transport services is equally unavailing. The BellSouth "evidence" consists of the totally unsupported statement that for high capacity services, competitors have captured "nearly 40 percent of the market in Atlanta and 30 percent in Florida."[34] Like Bell Atlantic, BellSouth provides no scale of measurement, but it is fair to assume that BellSouth is not providing actual lost revenue figures.

SBC's comments lack even an attempt to use DS1-equivalent losses as a way to demonstrate "robust" competition. Perhaps hoping that rhetoric rather than actual facts would enable it to make its strongest case, SBC makes the grandiose claim that because alternative network facilities exist in nearly every large metropolitan area, their existence alone effectively limits the ability of the ILEC to increase access prices.[35] This statement is incorrect and

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[32] Bell Atlantic Comments, at 10.

[33] Id., at 10-11.

[34] BellSouth Comments at 13.

[35] SBC Comments, at 4.

misleading. As AT&T notes, *all* of the SBC companies are pricing their Trunking baskets at the maximum the price cap rules permit.[36] It is, therefore, the price cap rules *rather* than transport competitors constraining the SBC companies from increasing rates even further. Moreover, if competitors were actually winning transport customers from the SBC companies based on price, a rational observer would expect to see SBC lowering its transport prices, but that is precisely the opposite of what is occurring. SBC is fully aware that it can price as high as possible and still maintain virtually all its transport revenues, and that is what it is doing. This is certainly one instance where actions speak louder than rhetoric.

SBC tries to minimize its astronomical market share of the transport market with assertions that this could change quickly because IXCs have purchased several alternative access providers.[37] While no doubt, MCI WorldCom benefits from the use of the existing Brooks and MFS networks, these facilities are located only on the vast minority of routes in metropolitan areas, and, at best, will meet only a small percentage of MCI WorldCom's access needs. The largest IXCs, and those with a broad residential customer base, must purchase access through virtually all of the approximately 20,000 end offices in the United States. Even the combination of facilities deployed by MCIMetro, MFS, and Brooks fails to provide MCI WorldCom with more than a small fraction of the facilities the company needs to reach its customers. It is also important to recognize that even when the purchase of an existing transport network does reduce entrance facility transport costs for an IXC, excessively priced collocations are still needed to reach the vast majority of end offices, and the IXC must still construct facilities at actual

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[36] AT&T Comments, at n. 7.

[37] SBC Comments, at 8-9. See also, Ameritech Comments, at 4-5 for a similar argument.

customer locations. As MCI WorldCom pointed out in its comments, these measures are extremely capital intensive and take considerable time.[38] Thus, regardless of the desire of MCI WorldCom to use competitive alternatives whenever possible, we will have to rely on the ILECs for the vast majority of our transport services for years to come.[39]

III. The Need For Rate Prescription

A. The Market-Based Approach Is Not Reducing Access Charges

MCI WorldCom strongly agrees with the many parties who observed that the market-based approach has failed to reduce interstate access charges.[40] Given the ILECs' success in squelching UNE-based entry strategies, the limited state of competitive development should come as no surprise. Indeed, not even the ILECs maintain that the market-based approach has achieved the Commission's stated objective of moving access charges toward forward-looking economic cost. Instead, they make a series of arguments that are alternately specious or irrelevant to the goal of achieving cost-based access charges. None of these arguments demonstrate that the market-based approach is likely to yield cost-based access charges any time in the foreseeable future.

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[38] See, MCI Comments, Rehberger Affidavit, at ¶. 32-43.

[39] Ameritech seems to put great stock in the fact that competitive access providers are adding customer locations each year in major cities. See, Ameritech Comments, at Appendix D. However, as MCI WorldCom pointed out, competitors' networks are connected to at most, 0.33 percent of the nation's commercial buildings and virtually no residential buildings. See, MCI WorldCom Comments, at n.14.

[40] E.g., Competition Policy Institute at 2 and Ad Hoc Comments at 3-10.

1. Commission Policy Should Promote Cost-Based Access Charges

Several ILECs have argued that the Commission should decline to prescribe cost-based access charges, not on the grounds that the market-based approach is working to reduce charges, but because basing rates on forward-looking economic cost would deter investment by the ILECs and entry by competitors.[41] In essence, they are asking the Commission to reconsider its announced policy in favor of promoting reductions to bring access charges in line with forward-looking economic costs. The Commission should unequivocally reject this back door attempt to seek reconsideration of an underlying requirement of the Access Reform Order.

There is no basis for the claim that reducing rates to forward-looking cost "would doom competition and investment."[42] If properly prescribed, access charges would allow ILECs to recover all forward-looking costs of providing access services, including the cost of capital. Such prescription would permit ILECs to achieve a normal return, which would provide appropriate market incentives for investment and entry.

Above-cost access charges substantially distort the market for interexchange services, seriously reduce social welfare, and enable ILECs to achieve extraordinarily high rates of return.[43] MCI WorldCom estimates that interstate access charges are at least $10 billion above

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[41] US WEST Comments at 17.

[42] Ameritech Comments at 11.

[43] MCI Absence of Competition in the Exchange Access Market Study, filed May 7 1998, as Ex-Parte in CC Docket No. 96-262 Consumer Federation of America, International; Communications Association and National Retail Federation Petition Requesting Amendment of the Commission's Rules Regarding Access Charge Reform and Price Cap Review for Local Exchange Carriers, RM 9210. Kelley Affidavit at Appendix B.

economic cost. The social welfare losses associated with them are undoubtedly higher. There is no justification for allowing this gravy train to keep running for even one day longer than necessary.

2. X-Factor Reductions Will Not Produce Cost-Based Access Charges

Some commentors argue that rate prescription is unnecessary because price cap regulation, via the X-factor, is already lowering access rates.[44] This argument is irrelevant to the achievement of cost-based access charges. Moreover, these same companies would gut future X-factor reductions by substantially lowering the X-factor.

The X-factor is designed to estimate achievable ILEC productivity gains. If it is an accurate estimate of such gains, then it can do nothing to reduce the gap between existing rates and the forward-looking cost of providing access service. Improvements in productivity represent reductions in forward-looking cost. If rates start out above cost, and each year ILECs achieve the expected improvements in productivity, then rates will remain permanently above cost. The X-factor will effectively preserve the relationship between rates and forward-looking cost. It will not narrow the gap.

It cannot be doubted that existing rates are substantially in excess of economic cost. Reliance on X-factor reductions will not yield cost-based access charges. Indeed, as MCI WorldCom has demonstrated, the X-factor substantially underestimates the ILECs' interstate productivity gains.[45] Accordingly, the gap between rates and forward-looking cost effectively

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[44] Ameritech Comments at 7-8, BellSouth Comments at 6.

[45] See MCI WorldCom Comments at 29-31.

widens each year. Ameritech's argument that low inflation has somehow enhanced X-factor reductions is completely baseless.[46] The purpose of the inflation adjustment is to keep real reductions constant. When inflation is low, nominal adjustments will be higher, but in real terms the adjustment is unchanged. Thus, a 4 percent reduction with an inflation rate of 2.5 percent is the economic equivalent of a 5 percent reduction when inflation is 1.5 percent.

Even if the Commission increases the X-factor to estimate ILEC interstate productivity improvements more accurately, it will never, by itself, yield cost-based access charges. First, the Commission must prescribe cost-based rates. Then, future X-factor applications will maintain the appropriate rate level.

3. Consumers Benefit From Access Reductions

ILECs continue to argue that the Commission should not reduce access charges, since IXCs do not pass through such reductions to end users in the form of lower long distance rates.[47] USTA has cited two reports that purport to purport to document this alleged exercise of market power.[48] As MCI WorldCom has shown, these reports are replete with errors and are simply incorrect.[49] Independent Wall Street analysis clearly demonstrates that long distance prices are falling faster than any reductions in access charges. For example, in a 10/2/98 report, Goldman

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[46] Ameritech Comments at 7-8.

[47] Ameritech even attempts to support this fallacious argument by taking two MCI WorldCom statements out of context and misrepresenting their intent.

[48] USTA Comments at 18.

[49] See letter from Michael D. Pelcovits, Ph.D, Chief Economist, MCI WorldCom to The Honorable William E. Kennard, Chairman, Federal Communications Commission, October 26, 1998.

Sachs shows that average long distance revenue per minute declined from the third quarter of 1997 through the second quarter of 1998.[50] Such a decline is inconsistent with USTA's assertions.

USTA's contentions are further rebutted by additional statements made by numerous industry analysts. For example, according to one analyst, "MCI posted a negative revenue to volume gap of 5.4% roughly in line with our expectations and wider than the negative 3.7% gap in 4Q97. The wider gap is primarily as a result of access charge pass throughs and strong demand for MCI's five cent Sunday program."[51] Finally, there is no economic theory that would support the type of behavior that the NERA studies attribute to IXCs. Even rational monopolists reduce prices in response to a reduction in costs. Thus, USTA offers dubious data to demonstrate behavior that cannot be explained by economic theory. The Commission should not be fooled by this smokescreen.

In addition, it cannot be doubted that the interexchange industry is fiercely competitive. Literally hundreds of long distance companies compete in the interexchange market. Moreover, as this Commission has found, not even AT&T, the largest IXC, exercises market power in the interexchange market. These undeniable facts are completely incompatible with ILEC claims that IXCs exercise market power by increasing rates when costs go down.

4. Irrelevance Of Additional ILEC Pricing Flexibility

Incredibly, several ILECs argue that it is impossible to judge the effectiveness of the

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[50] Goldman Sachs Investment Research, "Telecom Services: Third Quarter Preview," October 2, 1998.

[51] Linda Meltzer, UBS Securities, Report of 5/1/98.

market-based approach, without first providing them with substantial additional pricing flexibility.[52] In other words, they assert that the Commission must deregulate a group of monopolists in order to determine if competition is taking root. Neither economic theory nor Commission precedent supports this dangerously topsy-turvy approach to introducing competition to markets dominated by entrenched monopolists.[53] If adopted, it would expose the ILECs' customers, and nascent competition, to the full exercise of monopoly power.

All the Commission need do to judge the efficacy of the market-based approach, is to examine the ILECs' pricing behavior since the beginning of this experiment. If the market-based approach were working, the ILECs would be forced to price below cap for those services subject to substantial competition. The evidence unequivocally shows that the ILECs have continued to price interstate access charges at the maximum amount permitted under the price cap rules.[54] Indeed, some rates have actually increased.[55] Deregulating the ILECs at this time would allow them to increase many rates further, while narrowly targeting reductions to the small group of customers who have facilities-based alternatives. The Commission must insist on evidence of substantial competition prior to expanding ILEC pricing flexibility.

5. Relationship To Universal Service Reform

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[52] E.g., Bell Atlantic Comments at 2.

[53] See discussion of pricing flexibility in MCI WorldCom Comments at 43-66, and in Section V. below.

[54] AT&T Comments at 5-6.

[55] In the Matter of Petition of US WEST Communications Inc. for Forbearance From Regulation As a Dominant Carrier in the Phoenix, Arizona MSA, MCI Opposition, filed October 7, 1998, at 16, n. 28.

According to several ILECs, the Commission cannot even begin to evaluate the effectiveness of the market-based approach until after it removes all implicit subsidies from access charges and implements an explicit universal service fund.[56] There is no economic basis for this advice, which, if followed, would guarantee many more years of sacrificing the public interest to ILEC profitability. There is no reason why the Commission cannot, simultaneously with its consideration of universal service reform, develop a plan for bringing to access to cost on a date no later than the date where an explicit universal service fund is implemented.

In the past, the ILECs have complained that the failure immediately to remove implicit subsidies from access charges would create an incentive for inefficient competitive entry, since entrants would be able to avoid supporting universal service.[57] Now they appear to be arguing that the Commission should not evaluate the extent of competitive entry until after universal service reform takes place. In any case, it is undisputed that interstate access charges exceed their economic cost by more than the amount which is needed to fund universal service.[58] If the market based approach were working, competitive entry would already be putting pressure on above-cost access charges. The fact that it is not, makes it unnecessary to wait until after the implementation of universal service reform to evaluate the success of the market-based approach. The Commission should prescribe cost-based access charges to take effect no later than the implementation of universal service reform.

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[56] GTE Comments at 7-10, Bell Atlantic Comments at 5-7.

[57] GTE Comments at 4.

[58] MCI WorldCom estimates that access charges are at least $10 billion above cost, and that $2.5 billion is needed to support universal service for non-rural ILECs.

6. Cost Models

Bell Atlantic argues that the Commission should not prescribe cost-based rates because it cannot reliably estimate the forward-looking cost of access services.[59] This argument ignores the value of the substantial experience that the Commission and the industry have gained in establishing a cost model for universal service reform. The Commission should invite parties to submit cost models and comments on modifications to existing cost models, that would be necessary to estimate cost-based access charges. Given the experience that was gained from working on the model for universal service reform, there is no reason to believe that this could not be completed within a comparatively short time frame.

7. Legality Of Rate Prescription

Once again, ILECs have raised the tired claim that the prescription of rates to economic cost is not permitted by the Communications Act, and would also constitute an unconstitutional taking of property.[60] MCI WorldCom has previously demonstrated the baselessness of these claims.[61] The Supreme Court has held that a regulated utility has no right to the maintenance of a particular overall level of return.[62] Regulatory agencies are not required to maintain any specific

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[59] Bell Atlantic Comments at 6-7.

[60] US WEST Comments at 6, SBC Comments at 31-32.

[61] In the Matter of Access Charge Reform, CC Docket No. 96-262, MCI Comments filed January 29, 1997 at 28-32.

[62] Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944). The Court held that agencies are "not bound to the use of any single formula or combination of formulae, in determining rates."

rate methodology and are free to change their approach on a going forward basis.[63] Otherwise, the Commission would not have been able to replace rate of return regulation with price cap regulation. Neither the Communications Act nor the Constitution provides these monopolists with a guaranteed right to recover sums in excess of the economic cost of the services which they provide. MCI WorldCom urges the Commission to summarily dismiss these baseless claims.

8. Deployment Of Advanced Networks

BellSouth makes the remarkable argument that reducing access charges to their forward-looking cost is somehow inconsistent with the ILECs' incentive to deploy advanced networks, and that, therefore, rate prescription would be at odds with Section 706 of the Act.[64] The ILECs made this same outrageous claim when they were seeking a favorable price cap plan in 1990. Since then, video dialtone networks have fizzled, ISDN -- where it is available -- is priced quite high relative to local service, and the ILECs are now proposing that regulators give them ratepayer money so that ILECs can chase the Holy Grail of xDSL. In fact, above-cost rates undoubtedly reduce the ILECs' incentive to deploy new networks and services. New services might cannibalize the ILECs' existing monopoly revenue stream.[65] The fastest way to get widespread deployment of advanced networks is to get widespread deployment of competition -- not throw more money at ILECs via access charges. The Commission should reject BellSouth's

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[63] See, e.g., Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989).

[64] BellSouth Comments at 8.

[65] E.g., xDSL services might be highly substitutable for DS1s. In order to prevent the erosion of their high returns from DS1s, the ILECs will try to control such substitution. This incentive has probably delayed their deployment of advanced services.

illogical conclusion that above-cost access charges are essential to the deployment of advanced networks.

B. The Commission Must Prescribe Cost-Based Rates

MCI WorldCom urges the Commission to prescribe cost-based access charges to take effect no later than the date on which universal service reform is to be implemented. Most of the parties that recognized the failure of the market-based approach to reduce access charges, also recommended that the Commission prescribe rate reductions.[66] No party has proposed an alternative with any likelihood of achieving the Commission's goal of cost-based access charges. The Commission should immediately open a supplementary proceeding to establish forward-looking cost levels for access, by inviting parties to submit forward-looking economic cost models for Commission review.

Sprint recommended that the Commission solicit cost studies from the ILECs, and then use those studies to implement phased reductions in access charges.[67] However, as MCI WorldCom argued in its comments, such studies are inconsistent with incentive-based regulation and have not been demonstrated to be necessary in establishing analogous cost elements for local interconnection purposes. Econometric cost models are a more effective tool for determining forward-looking costs. In addition, there is no justification for the delay that a "transition" would entail. The public interest benefits of cost-based access charges have been withheld long enough. It is well past time to reduce these bloated charges.

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[66] Ad Hoc Comments at 10-12.

[67] Sprint Comments at 8-9.

IV. USTA'S Update of the FCC's TFP Study Gives Counter-Intuitive Results

USTA has presented an analysis which attempts to update the Commission's Total Factor Productivity (TFP) study to reflect data for 1996 and 1997. According to USTA, those additional two years of data show a decline in ILEC productivity, with the average productivity level achieved in the price cap years being 4.5 percent or lower.[68] In addition, USTA claims to have updated, but did not submit, its Total Factor Productivity Review Plan (TFPRP) model with 1996 and 1997 data. The TFPRP model also shows the average X-factor from productivity gains changing from 2.7 percent for the period 1991-1995, to 3.2 percent in 1992-1996, to 3.0 percent in 1993-1997.

As an initial matter, these results are inconsistent. USTA's update of the Commission's study shows a decrease in productivity since 1995, while USTA's update of its own study shows an increase. Even more striking, however, is the inconsistency of these results with the ILECs' financial performance since 1995. The ILECs have faced X-factors of 5.3 to 6.5 percent since 1995. Surely, if their achieved productivity had been only 3 to 4 percent, their reported earnings would have taken a nose dive.[69] However, their earnings have continued to climb, by about 0.6 percentage points a year on the interstate side, and based on their reports to Wall Street, are apparently continuing that climb this year.

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[68] USTA Comments at 22.

[69] A difference of 2.5 percent on the X-factor should have reduced their earnings by about 1 percent per year.

A. USTA's TFP Study uses Incorrect Data and Methodology to Compute Output Growth

Since USTA did not submit its TFPRP update, MCI WorldCom can make no comments on its validity. However, USTA's update of the Commission's study contains several flaws. In addition, the results rising from the update of the Commission's study highlight several issues with the methodology used in that study that may require revision, due to changes in the ILEC market since the Commission's original study. In conjunction with AT&T, MCI WorldCom has commissioned a revised study by Dr. J. R. Norsworthy.[70] That study makes several revisions to the USTA study, and details some issues that the Commission will need to resolve to properly update its TFP study.

The USTA study made a number of data revisions that are inconsistent with public record data. First, USTA estimated intrastate Dial Equipment Minutes (DEMs) for 1996 by assuming a growth rate of 4.5 percent over 1995. However, data for intrastate DEMs for 1996 are available from the Commission's Web site, and show a 6.8 percent growth rate from 1995 to 1996. USTA's artificially low growth rate for intrastate DEMs lowers overall output, and thus lowers the estimated productivity by 0.4 percentage points in 1996.

Similarly, USTA's demand for special access lines for 1997 appears understated. USTA uses a special access line count for 1997 of 24.5 million, whereas the preliminary Statistics of Communications Common Carriers reports a count of 27.9 million. Since the TFP factor is the difference between growth in inputs and growth in outputs, understating output growth, as USTA

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[70] See, "Reply Statement of Dr. Norsworthy," Attachment A to AT&T's Reply Comments (Norsworthy Study).

has in these two instances, results in a lower X-factor.

The sensitivity of the computation of the X-factor under the Commission's model to the growth in demand units is further evidenced by the effect of the use of number of calls as the demand units for local service. Since local revenue is a combination of per line and per minute charges for local service, and of charges for CLASS services, the most accurate estimator of demand for local services would be based on some weighted average of all of these types of outputs. For the sake of simplicity, the Commission in its study used local calls as a proxy for local demand, and USTA has continued that practice. So long as the several types of local services were growing at consistent rates, as they appear to have been in the Commission's original study through 1995, the use of number of calls as a proxy for local demand does not introduce a bias in the results of a TFP study.

However, in a world where the average length of calls is getting longer, or the use of CLASS services such as Caller ID and Call Forwarding is increasing, the use of number of calls as a proxy for local demand will skew the growth of outputs, and thus of TFP, downward. There appears indeed to have been such a change in demand. The ILECs have claimed that the increasing use of the Internet has caused an increase in the average length of calls.[71] In addition, more and more customers are subscribing to CLASS services.[72] Given this, the use of number of calls as a proxy for local demand in the years after 1995 will likely understate local demand growth, and thus understate total-company TFP.

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[71] U S West Comments at 8.

[72] See, e.g., "Half of Southwestern Bell's Customer Lines Now Have Caller ID", SBC Press Release, Thursday, November 5, 1998.

As one test of the effect of this understatement on TFP, the Norsworthy study computes TFP using minutes of use, rather than number of calls, as the demand units for local service. As can be seen by comparing the results in Tables D-1 and D-1A in the Norsworthy Study, this results in an increase in total-company TFP of 2.62 percentage points for 1996 and 4.48 percentage points for 1997. Clearly, the results of the Commission's methodology are very sensitive to the units of demand chosen.

B. The Treatment of Capital Costs in USTA's TFP Study Biases the Results Downward

In addition to the issues regarding the computation of outputs discussed supra, USTA's TFP study highlights a methodological issue with the Commission's treatment of inputs that causes the simple extension of the Commission's methodology to the new time period to result in an understated estimate of productivity. To compute the X-factor, the Commission summed the difference between ILEC TFP and economy-wide TFP and the difference between ILEC input prices and economy-wide input prices. To compute the input price differential, the Commission computed input price changes for labor, capital, and material for the ILECs. For the price of capital, the Commission used as its measure what it termed the "capital rental price," i.e., the ratio of property income with depreciation to the previous year's capital stock. The property income with depreciation was computed as revenue minus expense less depreciation.

This measure of "capital rental price" is in reality a capital charge to customers, which will only coincidentally reflect the ILECs' true cost of capital. If the ILECs' earnings rise substantially - e.g., because the Commission set the X-factor too low, or removed the sharing mechanism which capped ILEC earnings, then the ILECs' revenue would rise, which would in turn cause the property income to rise, which would raise the computed "capital rental price,"

thereby lowering the input price differential and thus the X-factor. Although this paradoxical result of higher earnings suggesting a decline in productivity is nonsensical, it is precisely the implication of USTA's productivity study.

For the period 1985 through 1995, for which the Commission had data when it performed its original study, this measure of the "capital rental price" gave fairly consistent results, because the ILECs' total regulated earnings were relatively constant, and the sharing mechanism prevented interstate earnings from rising substantially. However, the Commission adopted an X-factor option of 5.3 percent in 1995, which a majority of ILECs selected, that removed the ILECs' sharing obligation effective in 1996. In addition, beginning in 1996, ILECs' earnings at the state level took a sharp upturn.[73] Taken together, these two effects indicate that the ILECs' achieved earnings, as reflected in their revenues, increased sharply in 1996, even though their true cost of capital did not rise.[74] Thus, use of the Commission's method to compute the capital rental price after 1995 as USTA has done results in a conservatively low estimate of ILEC productivity.

C. Use of Interstate-Only Productivity is More Appropriate, and Requires an Increase in the Commission's X-Factor

As discussed in MCI WorldCom's comments, use of interstate-only rather than total

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[73] Based on data reported in ARMIS 43-01, total Bell Operating Company earnings for State and Interstate combined fluctuated between 10.1 and 11.2 percent from 1990 to 1995, rose from 10.9 in 1995 to 12.5 percent in 1996, and rose again to 13.6 percent in 1997. The increases in 1996 and 1997 occurred primarily because of substantial increases in the State jurisdiction, from 9.8 percent in 1995 to 11.8 percent in 1996 to 13.2 percent in 1997.

[74] Indeed, as MCI WorldCom demonstrated in its comments, the ILECs' true cost of capital has fallen from 10 percent to 9.1 percent.

company productivity is more appropriate. Other parties also argued for the use of interstate-only productivity factors. Indeed, as pointed out by Ad Hoc in its comments, even the ILECs have argued that the jurisdictions have different productivity characteristics that must be reflected in the productivity factor.[75] Of course, the ILECs have made that argument only when advocating a lower X-factor in the state jurisdiction.

Use of interstate-only data, along with the corrections discussed supra, results in an average X-factor for 1987 to 1997 of 10.0 to 10.4 percent, fully 4 percentage points higher than the Commission adopted based on its original study.[76] MCI WorldCom urges the Commission to revise its price cap plan to reflect the ILECs' true ability to achieve productivity improvements on their interstate services, and raise the productivity factor to at least 10 percent.

V. The Commission Should Reject USTA's Pricing Flexibility Proposal

While MCI WorldCom's Comments described a reasonable framework that outlined the conditions under which the ILECs could obtain contract pricing authority for transport services, USTA's latest pricing flexibility proposal is even more unreasonable than the proposals previously advanced by the ILECs in this docket and in the pricing flexibility phase of CC Docket No. 94-1. The new USTA proposal is little more than a "wish list" of pricing flexibility measures that would permit the ILECs to safeguard their access revenue stream and deter competitive entry. With few exceptions, the pricing flexibility measures proposed by USTA are

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[75] Ad Hoc Comments at 15-20.

[76] Because no correction was made for the bias resulting from the computation of the capital rental price using the Commission's methodology, this estimate is likely to be conservative.

not linked in any meaningful way to cost-causation principles or to the extent of competition in the access market.

As a practical matter, USTA's proposal would grant the ILECs almost complete pricing flexibility immediately. While USTA's proposed framework has three "phases," the Phase 1 package of additional pricing flexibility would eliminate the Part 69 rate structure, allow the ILECs to geographically deaverage switched access services, and permit the ILECs to offer contract pricing and term, volume, and promotional discounts. To obtain this near- complete pricing freedom, the ILECs would only have to show the existence of a state-approved interconnection agreement and a single competitor. Most ILECs would be able to satisfy this test today, even though there is no effective competition at all.

Several ILECs would probably argue that they satisfy USTA's Phase 2 transport and switched access "triggers" as well. Under USTA's plan, ILECs that can show that 25 percent of the market is "addressable" by competitors would be allowed to use a reduced X-Factor and would be permitted to combine today's price cap baskets into a single basket. Then, in Phase 3, those ILECs that could demonstrate that 75 percent of their market was "addressable" would be permitted to remove services from price cap regulation -- even though these ILECs would still possess market power.

The ILECs contend that they need this pricing flexibility in order to compete effectively. But the design of USTA's plan makes clear that the ILECs' real objective is to protect their access revenue stream from competition for as long as possible. USTA's proposal is designed to allow ILECs maximum flexibility to shift the "fat" in access charges -- particularly switched access charges -- to those services, geographic areas, and end users for which competition is

slowest to develop. USTA's proposal is also designed to give the ILECs the tools they need to deter competitors from entering the local market and to cross-subsidize those services subject to competition.

A. The Commission Should Not Adopt a Switched Access Pricing Flexibility Framework at this Time

Under USTA's proposed pricing flexibility plan, transport and switched access services are treated separately. An ILEC could, for example, obtain Phase 1 pricing flexibility for transport services before it obtains Phase 1 pricing flexibility for switched access services.

While MCI WorldCom generally agrees that transport and switched access services should be treated separately for pricing flexibility purposes, there is no need for the Commission to adopt a switched access pricing flexibility plan at this time. As discussed in MCI WorldCom's comments, there is virtually no competition for switched access services, nor any reasonable prospect that significant competition will develop in the foreseeable future.[77] Given that switched access competition has not developed, and that it is uncertain how such competition may develop, it would be premature to define the conditions under which additional switched access pricing flexibility would be granted.

Furthermore, the USTA plan and other switched access pricing flexibility proposals raise significant issues that would need to be addressed before the Commission could even begin to construct a switched access pricing flexibility framework. First, USTA and others have proposed that ILECs be permitted to geographically deaverage switched access rates and to offer volume

[77] MCI WorldCom Comments at 59.

discounts for switched access services. The Commission also included these proposals in the Access Reform Notice's discussion of pricing flexibility.[78] As discussed in more detail below, however, the record contains no evidence that the costs of switched access elements vary with location or with traffic volume.

Second, the ILECs appear to be requesting authority to geographically deaverage the SLC, even though the Access Reform Notice proposal would have preserved the current geographically-averaged SLC.[79] Deaveraging of the multiline business SLC raises significant issues. In particular, deaveraging of the SLC could lead several ILECs to price above the current $9.00 cap in rural areas, in order to offset rate reductions in more-competitive urban areas. It is not clear, however, that SLC rates greater than $9.00 would be consistent with Section 254(b)'s requirement that rates in rural and high cost areas be reasonably comparable to rates in urban areas. In the Access Reform Order, the Commission found that the $9.00 cap was "consistent with [the Commission's] long term universal goals in a competitive local exchange environment."[80] The impact on end users would be especially significant as long as access charges are well above cost; the ILECs could then use SLC deaveraging to shift all of the "fat" in common line rates to less-competitive areas.

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[78] Access Reform Notice at ¶¶180-192.

[79] While it is not clear from USTA's Comments whether it its requesting authority to deaverage the SLC, a recently-filed USTA Petition for Rulemaking asks the Commission to revise the Part 69 rules to permit such deaveraging. Petition for Rulemaking of the United States Telephone Association, ASD 98-97, September 30, 1998, at 53. See, Access Reform Notice at ¶180 ("In this Notice, we propose allowing incumbent LECs that have met the Phase 1 trigger to deaverage rates geographically for all access charge elements other than the SLC.")

[80] Access Reform Order at ¶82.

Finally, another feature of the USTA and Access Reform Notice proposals is that they would permit ILECs to offer switched access term plans and switched access contract pricing plans. But the ILECs have never explained how term plans and contracts are compatible with the structure of the switched access market. In the switched access market, IXCs pay the bills but do not choose the access supplier -- the access supplier is chosen by the end user as a byproduct of the choice of local exchange carrier. USTA does not explain how an IXC could reasonably commit to a switched access term plan or a switched access contract when it does not control the selection of switched access supplier. Under current Commission interpretation of Section 254(g), the IXC cannot even influence the end user's selection of originating switched access supplier through differential pricing of the interexchange service. Because the record does not explain how term plans and contract pricing would work in the context of switched access services, little purpose would be served by debating when the ILECs should be permitted to use such pricing.

B. There is No Cost Justification for Many of the Pricing Flexibility Measures Proposed by USTA

The Commission has permitted pricing flexibility for dominant carriers only when necessary to align prices more closely with costs.[81] If a particular pricing flexibility measure permits the ILEC to align prices more closely with cost, then additional pricing flexibility may

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[81] In the Matter of Expanded Interconnection with Local Telephone Company Facilities, Second Report and Order and Third Notice of Proposed Rulemaking, 8 FCC Rcd 7374, 7433 (1993) ("As a general matter, if volume and term discounts are justified by underlying costs, and are not otherwise unlawful, the LECs should -- indeed, must -- be allowed to offer them in order to encourage efficiency and full competition.")

be justified if adequate safeguards prevent anticompetitive behavior. The Commission should not, however, permit additional pricing flexibility that is not linked in any meaningful way to the manner in which ILEC costs are incurred. Pricing flexibility measures that are not necessary to align prices with costs simply provide a mechanism for the ILECs to discriminate unreasonably or deter entry.

Several pricing flexibility measures proposed by USTA, particularly for switched access, have no underlying cost justification:

1. There is No Evidence of a Cost Basis for Switched Access Volume Discounts

USTA proposes to allow ILECs that have satisfied its Phase 1 trigger to offer volume discounts for switched access services. As an initial matter, it is unclear how the volume discounts that USTA proposes would be structured. One possibility is that USTA's proposed volume discounts would be based on the volume of traffic at a particular end user location, as proposed in GTE's 1995 ZonePlus petition and in GTE's most recent Comments in this proceeding.[82] Another possibility is that USTA's proposed volume discounts would be based on the IXC's overall traffic volume.

There is, however, no evidence that switched access costs vary either with the traffic volume at a particular location or with an IXC's overall traffic volume. With the phaseout of the CCL and the TIC, the only remaining switched access element of any significance is the local switching element. There is no evidence in the record that the cost of local switching depends on traffic volume. Given that NTS local switching costs have been reallocated to the common line

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[82] GTE Comments at 28.

element, and that the local switching element now recovers only traffic-sensitive costs, it is unlikely that the incremental cost of a local switching minute would differ significantly from the average cost.

The only justification that has ever been given for switched access volume discounts is that volume discounts could offset some of the pricing distortions that result from the recovery of NTS costs through per-minute charges such as the CCL. A volume discount, it was argued, would reduce the artificial incentives to target high-volume users that are created by the recovery of NTS costs through per-minute rate elements.[83] The Commission cited this rationale in the Access Reform Notice's discussion of volume discounts.[84] But, as a result of the rate structure changes adopted in the Access Reform Order, this rationale no longer has any validity. The Commission solved the problem of per-minute recovery of NTS costs directly, by replacing the CCL with the PICC, transferring local switching line port costs to per-line elements, and transferring facilities costs from the TIC to other rate elements.

To the extent that the rate structure still permits per-minute recovery of NTS costs, the Commission should fix these rate structure problems directly. One obvious problem is the continued recovery of white pages costs assigned to the interstate jurisdiction through the

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[83]See, e.g., GTE Telephone Operating Companies Petition for Waiver of Part 69 of the Commission's Rules to Geographically Deaverage Switched Access Services, CCBPol 95-26, Sprint Reply Comments at 4 (". . . recovering these non-traffic sensitive costs on a minute-of-use basis provides higher-volume end users with uneconomic incentives to utilize special access or to bypass the traditional LEC altogether, because the access charges incurred by the IXCs in delivering traffic to, or receiving traffic from, that end user over the switched network are far greater than the interstate portion of the cost of that end user's loop. The volume discount GTE proposes would mitigate these perverse incentives and would be non-discriminatory.")

[84]Access Reform Notice at ¶190.

information surcharge and other per-minute rates in the traffic sensitive basket.[85] The Commission could solve this problem by reassigning white pages costs from the information surcharge, local switching charge, or other rate elements in the traffic sensitive basket to the marketing basket or common line basket, where these costs would be recovered primarily through per-line charges.

2. There is No Evidence of a Cost Basis for Geographic Deaveraging of Switched Access Rates

USTA also proposes to allow ILECs that have satisfied the Phase 1 trigger to geographically deaverage switched access prices. There is, however, no evidence in the record of a cost basis for the geographic deaveraging of switched access rates. First, the CCL and TIC are pure subsidy elements that, in any event, are being phased out rapidly. While the Commission permitted NYNEX to geographically deaverage the TIC in the USPP Order, it did so only because it found that the TIC included some revenues related to transport costs, which the Commission had found to be lower in higher-density zones.[86] Because nearly all of the transport costs previously recovered through the TIC have now been transferred to other rate elements, there is no longer any basis for geographically deaveraging the TIC.

For the other switched access rate elements, there is little or no evidence in the record that costs vary according to traffic density or other location-specific factors. The marketing charge

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[85]In the Matter of Petitions for Waiver Concerning 1985 Annual Access Tariff Filings, Memorandum Opinion and Order, rel. June 6, 1985, at ¶¶69-83.

[86]In the Matter of The NYNEX Telephone Companies Petition for Waiver Transition Plan to Preserve Universal Service in a Competitive Environment, Memorandum Opinion and Order, 10 FCC Rcd 7445, 7469 at ¶56 (1995) (NYNEX USPP Order).

and the information surcharge recover overhead costs that do not vary according to traffic density. The costs underlying the other switched access elements -- local switching, trunk ports, or STP port charges -- may vary with traffic density or other location-specific factors, but there is little or no evidence in the record to support such a finding. There is, in any event, no reason to permit geographic deaveraging of a switched access element unless the price of the corresponding UNE is also geographically deaveraged.

3. Differential Pricing According to End User Classification is Unreasonably Discriminatory

USTA's pricing flexibility framework would allow the ILECs to assess different switched access rates depending on whether traffic originates at a multiline business end user location or at a single line or residential end user location. The Commission has previously rejected such proposals, turning down NYNEX's request that it be permitted to establish different TIC rates for multiline business and residential users as part of its USPP plan.[87]

There is no reason to expect that costs would depend on whether an end user was classified as a multiline business or residential customer; the cost of a local switching minute for traffic originating at a multiline business location would be the same as the cost of a local switching minute originating at a residence. Differential pricing according to end user classification would therefore be unreasonably discriminatory, and would simply permit the ILECs to shift access revenues to residential minutes or lines, for which competition is likely to develop more slowly. An ILEC could then respond to competition for multiline business

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[87] Id. at ¶58.

customers without suffering any loss of access revenues, or could use increased residential revenues to cross-subsidize multiline business rates.

4. The X-Factor Should Not be Reduced as Competition Develops

USTA proposes to allow ILECs that have met the Phase 2 "trigger" to reduce their X-factor to GDP-PI, which would essentially freeze access rates. USTA argues that "[s]uch relief from price cap regulation as competition increases reflects the impact of competition on the ability to achieve the same productivity levels."[88] USTA contends that, as competition increases, ILEC output growth will decline and the ILECs will incur additional marketing costs.[89]

Not only is it purely speculative to expect that productivity growth will decline as competition increases, but competition is likely to cause productivity (like output) to improve even more quickly. In the interexchange market, AT&T's revenues and minutes grew rapidly even as competition increased and AT&T's market share declined.

As long as the ILECs remain dominant carriers with the ability to exercise market power, application of an X-factor based on actual ILEC productivity growth remains necessary to ensure that ILEC access charges are just and reasonable. Because ILECs satisfying USTA's Phase 2 trigger would clearly continue to possess market power, the reduced X-factor would allow the ILECs to increase their access rates to even higher levels. In fact, MCI WorldCom estimates that reducing the X-factor from 6.5 percent to GDP-PI in 1997 would have increased the ILECs' average interstate rate of return by 3 percentage points.

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[88]USTA Comments at 38.

[89]Id. at 27.

C. USTA's Proposed Triggers are Wholly Inadequate for the Pricing Flexibility Granted

Not only is there no cost justification for many of the pricing flexibility measures proposed by USTA, but there is no meaningful link between the degree of competition measured by USTA's "triggers" and the degree of pricing flexibility granted. In each phase of the USTA plan, the level of competition required to satisfy the trigger would clearly be insufficient to prevent the ILECs from using their additional pricing flexibility to discriminate unreasonably or deter entry.

1. Phase 1

An ILEC would satisfy USTA's Phase 1 trigger at the earliest stages of the development of competition. USTA would require only that the ILEC show that it has entered into a single interconnection agreement and that customers are utilizing a competitor's services. The ILEC could, for example, satisfy the Phase 1 transport test by showing that a single CLEC had entered into an interconnection agreement and that a single CLEC was providing alternative transport services on a single route.

USTA contends that its trigger "ensures that . . . competitors have the tools, including interconnection, access to UNEs, resale, collocation and reciprocal compensation, to 'win' a customer and reduces the costs of entering the market."[90] But, as the Commission has recognized in its evaluation of Section 271 applications, the mere existence of an interconnection agreement does not demonstrate that competitors have a meaningful ability to compete for the ILEC's business. USTA's Phase 1 trigger does not, for example, show that "competitors are able

[90] USTA Comments at 36.

actually to order and receive elements and services in a commercially reasonable manner and in necessary quantities" or that incumbent LECs have created "well-functioning and adequately sized provisioning systems."[91]

As discussed in more detail below, the minimal level of competition defined by USTA's Phase 1 trigger would not prevent the ILECs from using the pricing flexibility that would be granted in Phase 1 -- contract pricing authority, term and volume pricing authority, geographic deaveraging, and elimination of the Part 69 rate structure -- to behave anticompetitively:

a. Contract Pricing Authority Should Require a Showing of Substantial Competition

At the Phase 1 level of competition, contract pricing authority could easily be used for entry-deterring and predatory purposes. The ILECs could use contract pricing authority to offer targeted discounts designed to lock in customers or send a message to new entrants that they are unlikely to earn a normal rate of return on their investments.

Even the ILECs' consultants recognize that market power assessments should analyze the extent of sunk costs and the existence of barriers to entry.[92] An ILEC could, however, satisfy the USTA Phase 1 test even when there are minimal sunk costs and barriers to entry remain high. The USTA Phase 1 test simply does not examine the extent of competitors' facilities -- indicating sunk costs -- or examine whether CLECs are able to obtain UNEs in sufficient quantity and at

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[91] Access Reform Notice at ¶175.

[92] Richard Schmalensee and William Taylor, "The Need for Carrier Access Pricing Flexibility in Light of Recent Marketplace Developments," at 30-31 (attachment to letter from Mary McDermott, USTA, to Magalie Roman Salas, FCC, CC Docket No. 96-262, January 20, 1998.)

forward-looking cost -- indicating reduced barriers to entry. The USTA Phase 1 test would be satisfied as long as a CLEC's facilities were sufficient to serve a single customer and the CLEC had entered into an interconnection agreement, even if the CLEC had never successfully ordered a UNE. The USTA framework simply assumes that the existence of an interconnection agreement is sufficient to reduce barriers to entry.

The USTA Phase 1 trigger is completely inconsistent with Commission precedent, which permits contract pricing authority only if the dominant carrier can demonstrate "substantial competition."[93] The Commission's "substantial competition" standard requires that supply elasticity be sufficient to deter predatory pricing, as demonstrated by significant sunk costs or reduced barriers to entry. The Commission's substantial competition analysis also examines a variety of other factors, such as demand elasticity and market share, that are not addressed by USTA's test.

As discussed in MCI WorldCom's comments, the Commission should condition contract pricing authority for ILEC transport services on a demonstration of substantial competition. There is no reason for the Commission to define at this time the conditions under which contract pricing authority for switched access services would be granted, particularly since IXCs do not control the choice of supplier for switched access services and could therefore not reasonably commit to a contract or term plan.

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[93] In the Matter of Competition in the Interstate Interexchange Marketplace, Memorandum Opinion and Order and Order on Reconsideration, 6 FCC Rcd 5880 (1991) (Interexchange Order).

Ameritech, Ad Hoc, and certain other parties suggest that ILECs should be permitted to offer contract tariffs if an access customer issues a request for proposals (RFP).[94] However, the issuance of an RFP does not demonstrate substantial competition. The fact that a purchaser of access services may invite a service provider to participate in the RFP process does not mean that the invited vendor has the capability to provide the service. At this early stage in the development of access competition, an access customer may issue an RFP to determine whether a new entrant's network links the locations specified in the RFP or has sufficient capacity to meet the customer's needs.

b. Expanded Term and Volume Pricing at USTA's Phase 1 Would Allow the ILECs to Discriminate Unreasonably and Lock in Customers

Because most price cap ILECs already have term and volume pricing authority for transport services, the Phase 1 grant of "expanded term and volume pricing" would apply primarily to switched access services. As discussed above, it is not clear how term discounts for switched access services would work in a market where the customer -- the IXC -- does not select the supplier. In any event, at the early stage of competition marked by USTA's Phase 1, term discounts would simply provide a vehicle for the ILEC to lock in traffic and prevent even efficient entrants from securing economies of scale.

Similar considerations apply to switched access volume discounts. First, it is not clear if there is a cost justification for volume discounts. Second, even if there were a cost justification for volume discounts, the minimal level of competitive entry that characterizes USTA's Phase 1 competitive trigger would not be sufficient to prevent the ILEC from structuring its volume

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[94] See, Ad Hoc Comments at 27; Ameritech Comments, Attachment N, at 7.

discounts to discriminate unreasonably between access customers or to shift revenues to minutes or lines that are subject to less competition. For example, under GTE's ZonePlus proposal, which bases the discount on the traffic volume at the end user location, the ILEC could decrease rates for traffic originating at multiline business locations (where competition is likely to develop first) while increasing rates for traffic originating at residential locations.

c. Price Deaveraging in USTA's Phase 1 Would Allow the ILECs to Discriminate Unreasonably

Because most ILECs can already geographically deaverage transport rates, the Phase 1 price deaveraging provision would apply mainly to switched access services. As with volume discounts, however, it is not clear that there is a cost justification for geographic deaveraging of switched access services. And, even if there is a cost justification, deaveraging at the level of competition corresponding to USTA's Phase 1 trigger would simply permit the ILEC to shift revenues to areas where competition is likely to develop more slowly. The USTA proposal includes no safeguards that would ensure that the "geographically-deaveraged" rates charged in areas subject to less competition are cost-based.

d. Part 69 Codification Remains Necessary

Also in Phase 1, USTA would eliminate the Part 69 codification of access elements and would permit ILECs to introduce new switched access elements without a public interest showing. BellSouth contends that the Part 69 rate structure is no longer necessary to ensure that ILECs do not discriminate unreasonably between IXCs.[95] To the contrary, the importance of the Part 69 rate structure is increasing as ILECs enter the interexchange market. Without the Part 69

[95] BellSouth Comments at 15.

rate structure, the ILECs could introduce rate plans and rate elements tailored for their own interexchange operations, while increasing prices for rate elements purchased by other IXCs. The Phase 1 level of competition is not sufficient to prevent such unreasonable discrimination.

2. Phase 2

In Phase 2, USTA would reduce the X-factor and would eliminate the current price cap basket structure in favor of a single basket. ILECs would obtain this pricing flexibility by showing that 25 percent of their transport demand or local exchange service demand is "addressable."

As discussed above, there is no justification for ever reducing the X-factor. Nor does there appear to be any basis for restructuring the price cap baskets. In a footnote, USTA contends that the purpose of the realignment is to "align access prices with UNE prices."[96] However, USTA never explains what it means by "aligning" access prices with UNE prices or how the current basket structure prevents this realignment. If USTA means that the ILECs intend to reduce access prices to forward-looking cost, then MCI WorldCom would have no objection. But the price cap basket structure does not need to be realigned to permit this outcome. All that the ILECs need to do is reduce their rates.[97]

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[96] USTA Comments at 38, n. 58.

[97] By arguing that the structure of the baskets or service categories needs to be changed, USTA is saying that the current structure prevents ILECs from aligning prices with costs. But the current structure would prevent ILECs from aligning prices with costs only if the capped rate was below the forward-looking cost. There is, however, no evidence that any capped rates are below their forward-looking cost. Alignment of ILEC rates with costs requires price movement in only one direction -- down -- and therefore can be accomplished without any basket changes or service category changes.

Consolidation of the price cap baskets would permit the ILECs to increase rates for those services subject to the least competition. For example, it is likely that competition will develop more slowly for Traffic Sensitive basket and Common Line basket services than for Trunking basket services. If competition for transport services increases, it is possible that ILECs may begin to price below cap in the trunking basket. By combining the baskets, the ILECs would be able to increase their traffic sensitive and common line basket rates to take advantage of this headroom. Given that traffic sensitive and common line rates are above forward-looking cost even at their current levels, there is no justification for allowing these rates to be inflated further.

3. Phase 3

In Phase 3 of USTA's pricing flexibility framework, ILECs that are able to demonstrate that competitors are "capable of serving" 75 percent of the demand would be permitted to remove services from price caps. USTA does not explain how demand would be measured (minutes, lines, DS1 equivalents, etc.) or explain how it would be determined whether a CLEC was "capable of serving" that demand.

This standard is plainly inadequate for removing services from price caps. According to Commission precedent, services may be removed from price caps only if a dominant carrier can demonstrate "substantial competition."[98] In the AT&T proceedings, the Commission examined supply elasticity and AT&T's pricing behavior to find that price caps were no longer necessary to constrain AT&T's pricing. By contrast, the USTA test's focus on "addressability" is not sufficient to show that competitors can constrain the ILEC's pricing. First, the ILEC could

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[98]Interexchange Order, 6 FCC Rcd at 5894.

increase rates without restriction in the 25 percent of the market that is not addressable by a competitor. Even in the remaining 75 percent of the market that is supposedly "addressable," the USTA test does not establish that competitors are actually able to constrain pricing. In particular, the USTA test does not require the ILEC to demonstrate that UNEs can be ordered in commercially reasonable quantities or require any examination of the ILEC's actual pricing behavior.

VI. Access Charges Must Be Reduced To Economic Cost Before RBOCs Are Permitted Into The In-Region Long Distance Market And Further ILEC Mergers Are Approved

Commenters agree with MCI WorldCom that an RBOC's access rates must be at economic cost levels before they are permitted to enter the in-region interLATA market. For example, CompTel states,

> Above cost access rates in effect while a BOC provides interLATA services would grant the BOCs a significant competitive advantage over other long distance providers. This would distort competition and expose the competitive long distance industry to the market power of the largest incumbents, the BOCs.[99]

Furthermore, AT&T correctly recognizes that "the persistence of above-cost access costs pose a substantial risk with respect to the long-distance market because they give the LECs the ability to execute price squeezes against their interexchange rivals."[100]

The danger to interexchange markets from ILEC interLATA entry while access charges continue to be inflated above cost is very real and cannot be exaggerated. The Commission

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[99] CompTel Comments at 17.

[100] AT&T Comments at 11-12.

should affirmatively state in this proceeding that it will not grant a section 271 application unless access charges are reduced to economic cost.[101]

In addition, MCI WorldCom agrees with AT&T that further large ILEC mergers should not be permitted until access rates are reduced to economic cost.[102] AT&T correctly recognizes that allowing such mergers to occur, while access charges remain above economic costs threatens the public interest. Such mergers would give the merged entities an increased opportunitiy for effective price squeezes and would deprive consumers of potential competitors that could help drive access charges to cost in the affected market.[103]

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[101] Of course, this is in addition to the other section 271 requirements.

[102] AT&T Comments at 12-14.

[103] Id., at 12-13.

VII. Conclusion

For the foregoing reasons, the Commission should prescribe cost-based access charges no later than the date on which universal service reform for non-rural ILECs is adopted. Moreover, the Commission should increase the X-factor to at least 10 percent and decline to grant the ILECs' requests for additional pricing flexibility. The Commission should instead adopt the framework proposed by MCI WorldCom.

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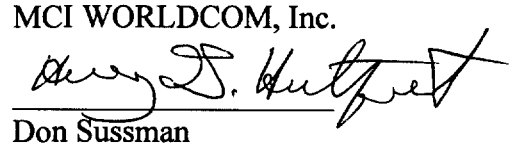

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I, Vivian I. Lee, do hereby certify that copies of the foregoing Comments In the Matter of Access Charge Reform, Price Cap Performance Reform for Local Exchange Carriers, Consumer Federation of America, and Petition for Rulemaking were sent via first class mail, postage paid, to the following on this 9th Day of November 1998.

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